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NSCIG/NEA 69-11
April 7, 1969

NSC INTERDEPARTMENTAL GROUP
FOR NEAR EAST AND SOUTH ASIA

Record of NSCIG/NEA Meeting - April 3, 1969

The meeting was devoted to the FY 1969 military credit sales program for Iran. The discussion focused on the Country Director's paper, with factual appendices, circulated prior to the meeting (NSCIG/NEA 69-9).

The Group agreed that our military credit sales program is the touchstone of our special relationship with Iran, which provides us with a variety of benefits in the political and security fields. Iran's support for the US position on numerous international questions and our own ability to influence the Government of Iran on regional matters (such as on a policy to promote peace and stability in the Persian Gulf) are valuable political assets. Our close relationship with Iran provides us with easy overflight and transit rights for US military aircraft, staging rights, and the hospitality of Iranian soil for important communications and intelligence facilities. Our military mission in Iran, whose continuance depends very largely on our ability to maintain a satisfactory military credit sales program, is the best channel we have to influence Iranian military thinking and specifically to limit pressures to divert Iran's resources unnecessarily to military purposes. The Group agreed that the importance of our ties with Iran has increased following Britain's announcement of its withdrawal from the Persian Gulf by the end of 1971, continuing Soviet inroads in the Middle East, instability in the Arab world, and recent events affecting the maintenance of US facilities in neighboring countries.

Ambassador Meyer noted that close collaboration between the United States and Iran is important for our ability to play an effective role in the area. The recent conclusion by Iran and Saudi Arabia of an agreement over the median line in the Persian Gulf was made possible, in part, by our good relationship with both countries. We are now trying to play a useful role regarding the future status of Bahrein. Ambassador Meyer stated that the Shah will be looking at our decision regarding military credit sales as a sign of the new Administration's attitude toward Iran.

Economic Factors. The Group noted the indications that Iran's economy is still booming. Real GNP has increased at an average annual rate of about ten percent over the last four years. Oil revenues have continued to rise, although not as fast as the Shah would have liked. Iran estimates its annual growth at 9.4 percent during the period of its

GROUP 3
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fourth 5-year plan, the first year of which has just been completed. Our Embassy in Tehran believes this rate is attainable. The IMF and the IBRD believe that Iran's economy is likely to grow somewhat more slowly, i.e., 7-8 percent a year, but even at that pace Iran's progress would be outstanding.

The Group agreed that, although Iran's economic progress has been unusually rapid, certain warning signs have developed. These include a decline in foreign exchange reserves, a growing debt service ratio, a substantial and rapid increase in budget outlay for military purposes, and a fairly static situation in agricultural output. Progress has been made in education and health, but much more remains to be done. Ambassador Meyer stated that the adverse financial trends arise largely out of Iran's desire to press ahead as fast as possible with both internal economic development and defense.

The Group agreed that the key question is whether the increase in Iran's income from oil will keep pace with the Shah's demands and Iran's expenditures. The annual disputes between the Government of Iran and the oil Consortium on the levels of oil exports and revenues are a matter of considerable concern. A breakdown in the Consortium-GOI relationship would endanger Iran's economic development and military programs as well as our own past major investment in Iran. In particular, the Group noted that shortfalls in the Shah's expectations for oil revenues should not mean that the development program would take the major reduction in favor of external defense expenditure, since the Shah's basic long-term security depends largely on economic and social development.

Ambassador Meyer noted that Iran's continued firm commitment to a vigorous economic development program is indicated by a recent shift of personnel which has brought Mr. Mehdi Samii, perhaps Iran's soundest financial leader, to the head of its Plan Organization.

The Group emphasized the importance of the continuing annual USG-GOI reviews of Iran's economic situation and its ability to finance its proposed military program. The results of the review recently concluded indicate that Iran's economy can carry the additional burden of a $100 million credit for military purchases from the United States this year, despite the matters for concern noted above. The annual economic review should continue to be a key part of our consideration of Iran's military purchases from the United States.

The Group agreed that at the present time Iran is not "diverting its own resources to unnecessary military expenditures to a degree which materially interferes with its development." This is the language of Section 35(A) of the Foreign Military Sales Act. The statement is considered valid whether or not Iran is properly to be considered a "developed" or a "less developed" country under the FMS Act.

<u>Military Factors</u>. The Group <u>noted</u> the following important factors influencing the Shah's thinking on Iran's military requirements: (1) the inherent Soviet threat to Iran remains; (2) the Persian Gulf is Iran's lifeline, and he is concerned over the possible opportunities for radical Arab inroads in the Gulf, possibly Soviet-encouraged, particularly after the British depart in 1971; and (3) Iran must be able to defend itself in the region. Noting these concerns of the Shah, the Group <u>agreed</u> that it is in the interest of the United States to maintain strong ties and effective influence with Iran, the most powerful Persian Gulf nation, and to encourage it to play a statesmanlike and constructive role in the Gulf. In this regard, it is important that Iran make a major effort to obtain the cooperation of other littoral states, particularly Saudi Arabia.

The Group <u>agreed</u> to recommend the sale this year of two F-4 squadrons desired by the Shah as a supplement to the two squadrons which we agreed to sell in 1966. The two additional F-4 squadrons are intended as a response to any possible threat posed to Iran by surface forces intruding into the Gulf, as well as against missile boats reportedly to be delivered to Iraq by the USSR. These aircraft, which have been recommended in the Persian Gulf Defense Study we carried out at the Shah's request, will take the place of a land-based missile system originally desired by the Shah. The Group <u>agreed</u> that it is in our interest to meet the Shah's request for delivery of the two additional F-4 squadrons by the end of 1971 when the British forces will leave the Gulf.

The Group <u>noted</u> that Iran continues to need US technicians (at GOI cost) for the first two squadrons of F-4's. It was <u>agreed</u> that, if requested by Iran, we make available for one additional year approximately 50 USAF technicians for duty in Iran on the understanding they would be replaced by civilian technicians thereafter if needed by Iran.

The Group <u>agreed</u> that certain lesser items desired by Iran should also be sold this year by the United States in addition to the two F-4 squadrons. These items might include an oil tanker, a floating crane, variable depth sonar installations, 18 Sheridan tanks and communications equipment, and a few other items, with an estimated cost of slightly under $20 million.

<u>Amount and Terms of Sale</u>. The Group <u>agreed</u> to recommend a FY 1969 military credit sale to Iran of $100 million of which at least $80 million should be applied toward the cost of F-4's and the remainder for other items. In considering lower and higher alternatives for the 1969 military sales credit figure, the Group concluded that $100 million was appropriate, among other reasons so as to avoid breaking through that annual planning ceiling with regard to subsequent years and also so as to meet a minimum requirement for the continuance of our relationship with the Shah.

Having in mind the desire of the Bureau of the Budget to reduce actual FY 1969 obligations below the sum authorized by Congress, the Group agreed that the $100 million credit package proposed for Iran in FY 1969 should include a private credit component of at least $20 million to be guaranteed by the USG. The balance would be in FMS direct credit by the US Government.

Ambassador Meyer noted the considerable importance attached by the Government of Iran to obtaining what it considers to be a satisfactory overall interest rate for the credit sales package. The Iranians have indicated their desire for an overall rate no higher than 6 percent. The Treasury representative noted that the present cost of money to the Treasury is 6¼ percent. The National Advisory Council had approved a guideline that in cases of mixed private and government credit the weighted average interest rate should not be less than the cost of money to the Treasury except in exceptional situations. This guideline anticipates that USG direct credit can be extended at below 6¼ percent so as to bring the overall package rate to that level. The Treasury representative estimated that, given the rates now prevailing in the private money market, which would apply to the $20 million minimum of private credit proposed for Iran, it would cost the US Government some $3 million to subsidize the direct government loan for the remainder of the $100 million package in order to bring the overall weighted average interest rate down to 6¼ percent.

The Group agreed that instructions should be given to the US negotiators to offer $80 million in USG credit at 6¼ percent and to offer a USG guarantee for private credit of $20 million at the current market rate. (The estimated average weighted interest for the total package in that event would be about 6-3/4 percent.) The Group agreed, however, that the question of the interest rate could be critical to the successful conclusion of negotiations with Iran, and that if it were determined necessary for successful negotiations, the interest rate for the direct USG portion of the total credit should be reduced sufficiently to bring the overall weighted rate down to 6¼ percent.

The Treasury and DOD (military assistance) representatives noted that we could meet two additional conditions set by the Government of Iran for including some private credit in the total package: (1) the sums borrowed from private sources would not be taken from already agreed GOI lines of credit in US banks, and (2) the sums borrowed privately for military purchases would be outside the ceiling prescribed in Federal Reserve guidelines on foreign lending by private US banks. While these points can be accommodated within our current policy and operating guidelines, the details would have to be worked out in actual negotiations with the private banks.

It had been estimated that it would cost Iran some $130 million for the two additional F-4 squadrons if ordered before June 1969. In view of the proposed limit of $100 million on the FY 1969 military sales credit, it had been proposed that the Government of Iran commit itself by a "Dependable Undertaking" for the total cost of the F-4's, but allocate only $80 million for that purpose out of the FY 1969 credit. Such an arrangement would permit Iran to utilize the remaining $20 million credit for other items in 1969. If there is a FY 1970 USG military sales credit, Iran could use it to pay off the balance of the undertaking for the F-4's; if not, the GOI would borrow commercially, pay the balance out of its own funds, or could cancel the contract. The Group agreed to recommend this procedure.

Summary Recommendations. The Group agreed to submit the following recommendations for approval by higher authority:

1) Extend to the Government of Iran (GOI), in FY 1969, $100 million in foreign military sales (FMS) credits.

2) Authorize the GOI to purchase two additional squadrons of F-4 aircraft through the Department of Defense on the basis of a "Dependable Undertaking" with the GOI utilizing at least $80 million of the FY 1969 credit to meet payments on this undertaking.

3) Authorize the GOI to utilize up to $20 million of the FY 1969 credit for defense items to be agreed upon in addition to the F-4's.

4) Provide the $100 million credit in a mix of direct FMS credit and USG-guaranteed private credit in proportions to be determined in the negotiations with the GOI, but with at least $20 million to be USG-guaranteed private credit.

5) Seek GOI acceptance of an interest rate of 6¼ percent (cost of money to the Treasury) for the direct FMS credit, and the current market rate for the USG-guaranteed private credit. However, if necessary for the conclusion of negotiations with the GOI, the interest rate for the direct FMS credit should be reduced to a level needed to bring the overall average rate for the total $100 million credit down to 6¼ percent.

6) If the GOI so requests, offer to make available for another year approximately 50 U.S. Air Force technicians for duty in Iran on a reimbursable basis, on the understanding that thereafter civilian technicians may have to be utilized.

7) After Executive Branch approval of this program and before its presentation to the Shah, undertake consultations to apprise appropriate Members of Congress of the program and obtain sympathetic understanding of our reasons for undertaking it.

8) Instruct Ambassador Meyer, when presenting the program to the Shah, to include appropriate remarks touching on Iran's economic situation, GOI obligations under the "Dependable Undertaking" for the F-4's, and the purposes for which the funds are provided.

9) Make a finding, if needed, that Iran is not diverting its own resources to unnecessary military expenditures to a degree which materially interferes with its development.

Sidney Sober
Staff Director

<u>Members present</u>:

Chairman:	Mr. Sisco
ACDA:	Mr. Van Doren
AID:	Mr. Williams
CIA:	Mr. Blee
DOD:	Mr. Schwartz
JCS:	Brig. Gen. Doyle
NSC:	Mr. Saunders
Treasury:	Mr. Hausman
	Ambassador Meyer
AID:	Mr. White
BOB:	Mr. Shaw
DOD:	Mr. Fede (ODMA), Mr. Reed
State:	Mr. Rockwell, Mr. Eliot
	Staff Director